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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 72–1490

FEDERAL POWER COMMISSION, PETITIONER

v.

TEXACO, INC., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

REPLY BRIEF FOR THE FEDERAL POWER COMMISSION

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1. The issue in this case is *not* whether the Federal Power Commission can exempt small producer sales from all rate regulation under the "just and reasonable" standard of the Natural Gas Act. The Commission has not claimed such authority, and we do not argue that the statute permits it. The contention (*e.g.*, Phil. 22–26) [1] that the Natural Gas Act requires rate regulation of all producers under the just and reasonable standard is thus beside the point, unless, as some

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[1] We use the following abbreviations to signify the briefs of the respondents: "INGAA" (Interstate Natural Gas Association of America); "Phil." (Phillips Petroleum Company); "PSC" (Public Service Commission of the State of New York); "Tenn." (Tennessee Gas Pipeline Company); "Tex." (Texaco, Inc.).

respondents argue and as the court of appeals erroneously concluded, the Commission's order does in fact abandon that standard.

The argument takes several forms. First, some respondents (PSC 18–31; Tenn. 15–16, 27–30), echoing the court of appeals' opinion (Pet. App. 12a), contend that Order No. 428 ties the reasonableness of small producer rates exclusively to two factors that the Commission does not and cannot regulate: "highest contract prices for sales by large producers" and "the prevailing market price for intrastate sales in the same producing area" (App. 142). There is no doubt that the Commission's determination of the reasonableness of small producer rates will depend in part on those field price factors. But, as we showed in our opening brief (pp. 17–19), the order does not mean that those factors are the only ones that will be considered. It states only that the reasonableness determination will include "appropriate comparisons" (App. 140, 142) of the small producer's contract price with the two market factors.[2] The Commission stated that it would "consider *all* relevant factors"[3] (App.

[2] The Court thus need not reach the question whether, as suggested in *Permian Basin Area Rate Cases*, 390 U.S. 747, 795, the Commission could properly conclude in advance that market prices will be deemed "just and reasonable." Nor need it consider whether the present record could support such a determination. To state that the reasonableness of small producers' rates will be reviewed in light of "appropriate comparisons" with prevailing field prices is quite different from saying that the prevailing field prices are in all cases just and reasonable.

[3] The order does not spell out all the factors that may bear upon the reasonableness of a particular rate, but the relevant

142; emphasis added) in making its determination.[4]

Second, it is argued (Phil. 28; Tenn. 12–15) that just and reasonable cannot be the order's standard, because the order contemplates freeing small producers' rates from the constraints of the established maximum area just and reasonable rates. But even the court of appeals recognized (Pet. App. 16a; see also, PSC 30–31) that "just and reasonable" rates for small producers may be at a different level than for large producers. The Commission has not determined in Order No. 428 what that different level will be. But it has indicated that small producers' rates may be

considerations will not be difficult for sophisticated pipelines and producers to discern. Among the factors may be the producer's costs (which the pipeline is free to ascertain at the time the contract is negotiated), the nationwide average of producers' costs (ranges of which may be found in the Commission's recent rate decisions and in cost submissions in pending rate proceedings), the pipeline's need for the gas, the availability of other gas supplies, the amount of gas dedicated under the contract, the rates of other recent small producer sales in the area that have been approved for flow-through by the Commission, and any other consideration that may suggest the reasonableness of the rate in the particular circumstances. The Commission's early determinations under the order presumably will provide even further guidance.

[4] New York erroneously contends (PSC 22–23) that "all relevant factors" come into play only if the rates are higher than the two market price factors, and that a pipeline would therefore be permitted to pass on even an unreasonably high rate if it were justified by reference to other "factors." There is, however, no basis for that strained interpretation of the order. It plainly contemplates that the other "relevant factors" are to be considered, together with the prevailing field prices, in determining whether a particular rate is unreasonably high. There is nothing to indicate that the Commission will permit *any* unreasonably high rate to be passed on by a pipeline.

reasonable even if they exceed the level that is reasonable for large producers.[5] That determination is a permissible one in view of the unique "problems and public functions of the small producers" (*Permian, supra,* 390 U.S. at 787), and it does not represent a departure from the statutory standard.

Third, some parties contend (INGAA 19–20; Tenn. 14) that, if the order truly guaranteed just and reasonable small producer rates, there would be no need for the pipeline to justify its purchased gas costs before passing them on in the form of higher rates. But that assumes the reasonableness determination must be made in advance of the pipeline's purchase. The scheme of this regulatory plan is to defer the determination to the stage at which the pipeline seeks to flow through its purchased gas costs. If it can show that those costs—*i.e.,* the small producer's rates—are not unreasonably high, it will be permitted to pass them on. If not, it may not pass them on. The result—reasonable rates—is the same; the Act does not require that the Commission's review take place at a prior stage.

Fourth, it is urged (INGAA 22, 24; Phil. 31–32; PSC 37) that the order departs from the statutory standard at least with respect to the rates collected by

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[5] Tennessee (pp. 32–33) apparently misunderstands our point to be that the small producer rates will be held to the area maximum. We do not say that. We say that the Commission need *not* establish a single maximum applicable to all producers but may treat different classes differently. Section 16 of the Act, 15 U.S.C. 717*o*, provides that the Commission "may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters."

a small producer prior to any prospective reduction that may be ordered by the Commission upon a determination that the level is unreasonably high. It is true that small producers will not be required to make refunds for that period, but that is not an abandonment of the just and reasonable standard. The Commission *may* but is never *required* under the Act to order refunds of unreasonable rates (see 15 U.S.C. 717c(e)). *Placid Oil Co.* v. *Federal Power Commission*, 483 F. 2d 880, 905 (C.A. 5), pending on writs of certiorari, Nos. 73-437, 73-457, 73-464; *Public Service Commission of the State of New York* v. *Federal Power Commission*, 329 F. 2d 242, 250 (C.A. D.C.), certiorari denied *sub nom. Prado Oil & Gas Co.* v. *Federal Power Commission*, 377 U.S. 963; see, also, *Permian, supra*, 390 U.S. at 826-828. The Commission determined in Order No. 428 that it would serve the public interest—by allowing small producers to rely on their collected rates in making plans for exploration and by giving pipelines an incentive to bargain hard—to indicate in advance that it would not order refunds of rates collected prior to any prospective reduction. That determination is a reasonable one; it is at the heart of the Commission's regulatory plan for small producers.[4]

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[4] Several respondents argue that the Commission will not make even prospective reductions of rates found to be unreasonably high (INGAA 23-24; PSC 35-36; Tenn. 13, n. 13). They rely on a statement in the order that the Commission seeks "to assure the small producer that * * * the provisions of his contract will not be subject to change" (App. 137). But that statement, read in the context of the entire order, including the Commission's determination to permit the passing on only of

Fifth, two respondents argue (Phil. 30; PSC 42-46) that the Commission's determination to permit the flow through of increases authorized under *existing* small producer contracts without requiring the pipeline to demonstrate that they are not unreasonably high (see App. 246, n. 5), is an unlawful abandonment of the just and reasonable standard with respect to those rates.[7] The Commission, however, is familiar with the rate levels contained in existing contracts (which are required to be filed), and the order simply reflects its judgment that those levels are not unreasonably high. Even so, the order does not foreclose the Commission from adjusting its position in this respect if experience shows that its judgment was incorrect. The Commission intends to monitor closely the results

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reasonable rates, means only that the contract will not be subject to retrospective change by way of a refund order. There is no basis for concluding that the Commission has decided not to exercise its authority to reduce unreasonably high rates. That would leave a pipeline in the position of having to absorb the unreasonable excess over the life of the contract, and there is nothing in the order to suggest that the Commission intends that result.

Nor is this plan "self-defeating" (INGAA 23). The Commission reasonably concluded that the no-refund assurance would adequately stimulate exploratory activity and would provide a sufficient bargaining incentive to the pipelines and large producers.

[7] Neither Phillips nor New York made this claim in its petition for rehearing before the Commission (see App. 214-220, 221-237), "a step required by § 19(b) of the Act in order to preserve a point for judicial review" (*Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 307). The only contention made by New York with respect to sales under existing contracts was that any increase in the rates for those sales would not effectively stimulate new exploration (App. 217).

of its order and to take whatever further action is necessary "to protect the consumers" (App. 145).[8]

Finally, it is argued (PSC 38-39; Tenn. 42-44) that the standard traditionally applied in pipeline rate proceedings is one of "prudence" rather than "reasonableness," and that the order therefore portends a departure from the statutory standard. Even assuming that there is any substantial difference between a prudent expense and a reasonable one, Order No. 428 makes it entirely clear that reasonableness will be the standard in the context of small producer rates.[9]

2. Several of the respondents contend (INGAA 16-19; Phil. 22-26; Tenn. 16-23, 33-34; Tex. 4-9) that the Natural Gas Act requires that producers' rates be regulated directly and precludes indirect review at the pipeline level. In arguing that direct regulation is required, however, respondents succeed only in showing that some form of effective regulation is required. The Act does not specify the method to be used; it only establishes the result that must be reached. If, as we have shown, the Commission's plan is reasonably de-

[8] New York argues (PSC 44-45) that existing revenues and incentives are adequate to encourage exploration by small producers and that there is thus no reason to permit rate increases authorized under existing contracts. But this is manifestly a judgment for the Commission, and New York has not shown that the Commission's determination that this additional revenue would facilitate further exploratory activity is unreasonable.

[9] The Commission recently suspended a pipeline rate increase based on a new small producer contract under Order No. 428, on the ground that "the contract rate has not been shown to be just and reasonable * * *." *Trunkline Gas Co.*, Dkt. Nos. RP72-23, *et al.*, issued January 31, 1974.

signed to ensure just and reasonable small producer rates, the Act is not offended because the manner of the regulation is not direct.

Similarly, in arguing that the Act provides no authority for indirect, pipeline-level review of producers' rates, respondents succeed only in showing that indirect regulation has not been tried before and that the statute does not spell out in so many words the Commission's authority to try it now. But the Commission is not forbidden to try new methods of regulation designed to serve the public interest more effectively than the old. And the absence of specific authority to undertake a program of indirect review is not a bar to doing so. The Act gives no specific authority to regulate rates directly, either. The fact is, as we have stated, that the statute does not specify any particular method of regulation. That is why "[u]nder the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling" (*Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602).[10]

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[10] There is no merit to the claim (INGAA 27–29; PSC 35; Tenn. 35) that Order No. 428 represents a return to the situation that existed prior to this Court's decision in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, where it was first held that the Commission has jurisdiction over wellhead sales of natural gas in interstate commerce. The Commission's review of the pipeline's purchased gas costs here will be undertaken with an eye not only toward the reasonableness of those costs but also toward the reasonableness of the rates. Unlike the situation prior to *Phillips*, the Commission may order the prospective reduction of any small producer rate found to be unreasonably high.

3. The respondents make a variety of other attacks upon the Commission's order, asserting that it is unreasonable, unfair, discriminatory, vague, impractical, and ineffective. None has merit; most have been answered in our opening brief. We allude here only to those we had not anticipated.

a. The pipelines and large producers complain that the Commission's order discriminates unfairly against them. The pipelines contend (INGAA 25; Tenn. 36–37) that the order is unfair because they had not, since *Phillips*, *supra*, been required to bear the burden of justifying their purchased gas costs, and that Order No. 428 subjects them to "new risks" (Tenn. 37). They claim it is unfair to impose this "new" burden of keeping their costs to a reasonable level because the current gas shortage "has created a strong sellers' market" (Tenn. 31). As the Commission indicated (App. 245), however, pipelines have always had the burden of demonstrating that their costs—"including the cost of purchased gas" (*ibid.*)—are reasonable. While the regulatory scheme of Order No. 428 places a new "emphasis on that duty" (*ibid.*) with respect to purchased gas costs, that does not give rise to a new risk but only highlights an existing one. It goes without saying that the Commission will not permit any substantial deterioration in the financial health and integrity of the interstate pipelines. If, contrary to the Commission's reasonable expectations, the new regulatory plan leads to any such result, the Commission is free to make the necessary adjustments.

The large producers argue that they are disadvantaged because their contracts may not permit them to pass on the increased costs of gas purchased from small producers, whereas the pipelines will be in a position to do so (Phil. 35–38, 39–40). But that results from the terms of the producers' contracts (which commonly do not allow for tracking increases), not from the Commission's order. The Commission itself, in a separate proceeding under Section 5(a) of the Act, 15 U.S.C. 717d(a), may in appropriate circumstances establish rates higher than those specified in a contract. But it has no authority to permit large producers or pipelines themselves to raise their rates in excess of the maximum authorized in their contracts. *Federal Power Commission* v. *Mobile Gas Service Corp.*, 350 U.S. 332; *Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U.S. 348. That the pipelines have contracts permitting increases while the large producers do not is no reason to invalidate the Commission's order.[12]

b. Tennessee (pp. 39–41, 41–44) claims that the "unreasonably high" standard in Order No. 428 is too vague, and it poses a series of questions in an effort to demonstrate ambiguities. But it is obvious that the

[12] The large producers also claim (Phil. 38–39) that they are competitively disadvantaged because small producers will be in a position to commence sales without waiting for Commission certification. But this is true even now under the existing small producer certificate program, which permits small producers to obtain blanket certificates authorizing in advance any new sales that do not exceed the maximum area rate. See Order No. 308, 34 FPC 1202.

answers to those questions would raise still further questions. The difficulty, if there is one, is inherent in any attempt to apply a general standard in the abstract. The answers to Tennessee's questions, to the extent those questions have practical significance, will become apparent once the program is fully under way and the Commission has had an opportunity to consider the reasonableness of specific small producer rates.

c. Other respondents raise similar objections related to the practical operation of Order No. 428 (INGAA 24, n. 12; Phil. 29; PSC 17, 39-41). But the concern over how the Commission will assess the reasonableness of rates without undertaking a burdensome proceeding in each case is premature. If the Commission finds, after some experience, that the program cannot be managed properly as now established, it will then be in a position to make any necessary adjustments. Similarly, if those who are affected by the order find that its operation raises difficulties not anticipated by the Commission, there is no reason to believe that the Commission will inflexibily resist making appropriate accommodations.

d. Finally, Tennessee contends that Order No. 428 will not accomplish its objective of stimulating exploration (pp. 46-49), that the costs to pipelines and consumers will be disproportionate to the benefits that will result (pp. 49-53), and that the order will not reduce the Commission's administrative burdens (pp. 53-54). These are challenges to the wisdom, not the

lawfulness, of the Commission's determinations. An order may not be invalidated simply because one party or another disagrees with the allowable judgments of the regulatory agency.

Respectfully submitted.

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